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Keeping Activist Investors Away

Ways to keep activist investors away include boosting performance, improving capital allocation and strengthening your competitive edge.

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For those who thought activist investing was a fad that would run its course and fade away, wake up and smell Carl Icahn's coffee. Shareholder activism is here to stay.

There are more and more activist investors backed by ever-increasing war chests that keep filling up in response to activist success. Pension funds and other investors search high and low for decent returns and many seem convinced that activist investors can deliver the goods.

What drives shareholder activism and its success? Unfortunately, many companies are not run as well as they should be, which allows activists to find companies with performance problems, inadequate valuations and governance troubles. They buy in cheap, apply pressure to move management in a new direction and then seek to sell at a higher valuation.

Frankly, it can be embarrassing for executives that outsiders can be so successful without the benefit of inside information available to management. It should be much easier for management to drive these kinds of successes from the inside.

On top of this, in an environment where the public trust of corporate leaders has faded, activist investors have garnered an almost Robin Hood-like image as combatants of greedy, power hungry CEOs. Since activists usually own less than 10 percent of the company, the vast majority of any gains they stimulate are realized by other investors, including pension funds which invest on behalf of the masses. Activist activity seems almost altruistic.

ANALYSIS

The experience is very different from a corporate perspective. Many executives find dealing with activists to be very unpleasant. It is difficult to lead a company toward long-term success while a seemingly naïve outsider acts like a bully with a megaphone and cries out grievances for all to hear. Activists are disruptive, unsettling and downright frustrating.

Activists complain about deteriorating competitive advantages, weak revenue growth, declining profit margins and/or eroding returns on capital. They whine about slumping valuation and poor share-price performance. They often demand for the business to be broken up through spinoffs and divestitures or for it to stop its acquisitions. And they often insist on massive stock buybacks, sometimes funded by taking on heavy levels of debt.

They wax eloquently about governance problems like board cronyism and seem to almost enjoy shouting about what they see as undeserved executive pay. Pity the CEO's children who get teased and tormented at school because their parent is condemned on TV for making millions in supposedly undeserved salary, bonuses and stock options.

The threat of an activist appearing in your investor register is very real. If you lead a public company in the United States, it is guaranteed activists have already evaluated you and your company. If they don’t take action now, they will nonetheless regularly reevaluate your company to see if it fits their targeted profile. Who would have thought Apple, the third-best performing stock in the S&P 500 over the last 10 years, would attract an activist?

Some executives and directors lose their jobs at the hands of activists. Some companies are broken up into pieces. Some carry out massive restructurings replete with thousands of layoffs and other cost cutting. It all seems so threatening and distracting.

But it doesn’t have to be. As in sports, when dealing with activist investors, the best defense is a good offense. To keep activists away, you must be your own activist!

There is plenty an executive team can do to keep activist investors looking elsewhere, but it requires letting go of some often deep-seated beliefs. Executives must not view the company as theirs, but as the property of the company’s shareholders. Shareholders are often silent partners. But remember that any investor can become vocal and exert influence as he or she desires.

If management is truly committed to serving shareholders, it should evaluate the business the way activists already do and take decisive action to unlock value before activists barge in and force management’s hand. Being proactive gives management the opportunity to do it right since they know the company best.

There are five main areas in which management should take steps to keep activist investors away:

1. Improve Performance: Are revenue growth, profit margins and returns on capital adequate in each major business area? Are there opportunities for improvement? Seek to better utilize all unutilized capacity, since this can drag down returns on capital. Reduce bureaucracy that adds cost, complicates decision making and breaks down accountability. Discontinue all activities that don’t earn adequate returns because these are magnets for activist investors.

2. Allocate Capital Better: Do you have the right balance between organic investment, acquisitive investment, dividends and buybacks? Are investments made in the right areas? Do you invest more where returns and growth opportunities are high, and vice versa? Activists frequently target companies that allocate capital poorly.

3. Strengthen Competitive Advantages: Are your competitive advantages adequate to support growth and sustainability? Do you invest enough in research and development? Brand-building marketing? Employee training? Weakening competitive advantages cause low valuations and can be an invitation to activist investors.

4. Separate Unrelated Businesses: Is management distracted by trying to run too many different kinds of businesses? Are smaller, fast-growing business areas stifled and investing less than they would as stand-alone companies? Management should separate unrelated parts of the business via spinoffs or divestitures. Conglomerates tend to grow slower and be valued lower than focused companies and, therefore, often attract activist attention.

5. Strengthen Corporate Governance: Do your incentives motivate managers to think and act like owners? Do they treat the capital of the company as they do their own money? Have executives been overpaid relative to the performance they have delivered? Activists will rarely enter a stock just because of poor governance, but egregious compensation and other governance weaknesses can support their case among other investors and the public.

To successfully serve as your own activist, you must objectively assess your company's strengths and weaknesses and diligently pursue improvement opportunities. This can be tough especially when a CEO or CFO decides to impose unwanted change on friends and colleagues. If you are such a friend or colleague, remember it is probably better to take action yourself than to have your hand forced publicly by an activist.

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